Digest of a Performance Audit of Utah Water Loan Program

This study focuses on issues surrounding the state's water loan program. In general, our study found that many of the issues pertaining to the water loan program are contingent upon the Legislature's intended objective for the program. Policy decisions regarding the level of assistance the state should provide for water development, the size of the state's water loan program, and how the program is funded will all impact the direction of the program. Specifically, our review of financing approaches available for use in the water loan program concluded that given the same amount of state funding, more water projects can be financed with interest rate buy-downs than revolving-loans; buy-downs require fewer state dollars to finance the same number of projects as revolving-loans; and if funded at the same level as the revolvingloan program, buy-downs can be used to maintain a balance of funds in the program. Revolvingloans maintain a balance of funds in the program; provide convenient financing to communities unable to access the market; and allow state agencies flexibility in extending and restructuring loan terms. Our review of funding methods concluded that the Legislature should consider alternative funding methods that have been proposed to supply capital to the water loan program. And our review of consolidation of the four water boards concluded that consolidation would probably not result in significantly greater efficiency.

Under the current program, the state assists local governments with water development projects by providing low interest rate loans. These loans are typically 2 to 5 percent below the prevailing market interest rate. In order to secure a loan from the state, local governments sell bonds to the state which bear the same interest rate as the interest rate on the loan they receive. The state currently holds approximately \$324 million in outstanding bonds in its water loan portfolio. The state's water loan program is administered by four water boards: the Water Resources Board, the Drinking Water Board, the Water Quality Board, and the Community Impact Board (CIB). The water loan program is currently funded through state appropriations, federal appropriations, interest earned on revolving-loans, and mineral lease revenue.

Recently, political leaders and finance professionals have raised questions about the way the water loan program is administered. Their concern has centered on: a) whether more projects could be financed by using state dollars for interest rate buy-downs instead of revolving-loans; b) whether there are better ways to fund the program; and c) whether consolidation of the four water boards under a single board would result in greater efficiency. Critics of the current program argue that the state should not be so heavily involved in the banking business. The state's water loan portfolio is larger than the municipal bond portfolio of some of the state's largest banks. The critics wonder how large the program will eventually become and what level of funding it

will take to maintain the program. Our office was asked to study the above issues and provide information back to the Legislature. A summary of our findings is outlined below:

Choice of Financing Approach is a Policy Issue: The decision of whether to emphasize the use of interest rate buy-downs or revolving-loans in the state's water loan program is a policy issue dependent on the Legislature's objective for the program. Is the objective of the program to finance as many projects as possible? Should more projects be financed now or in the future? How much money should the state appropriate to the water loan program? Is the program currently large enough, too large, or not large enough? As the state continues to grow and the demand for water development projects increases, the objective of the program should be made clear and set forth in policy by the Legislature. The answer to these policy questions will determine whether the interest rate buy-down approach or the revolving-loan approach should be emphasized in the water loan program.

Our comparison of interest rate buy-downs versus revolving-loans determined that the use of in the water loan program will allow the state to finance more water projects with the available state funds. Buy-downs can also be used to finance the same number of projects as revolving-loans but with fewer state dollars. If funded at the same level, the buy-down approach can match the projects financed under the revolving-loan approach and still maintain a balance of funds in the program similar to the revolving-loan approach. On the other hand, revolving-loans finance fewer projects with available state funds but maintain a balance of funds in the program. The revolving-loan approach also offers easy and convenient access to financing for local governments that are unable to access the market. State officials also report that the flexibility of revolving-loans allows them to make special financing arrangement and restructure loan terms when necessary. Some costs of accessing the market are also eliminated under the revolving-loan approach.

Under the buy-down proposal, water projects would be financed through a combination of loans from the private sector and financial grants from the state. Grants from the state would be used to reduce the commercial rate on the private sector loans to a more affordable level (i.e., interest rate buy-down). The size of the grant would be negotiated between the community and the water board just as interest rates are determined under the current revolving-loan approach. Under this approach, the state would no longer be the primary lender on water projects. Instead, the state would be the lender of last resort, only making loans to communities unable to access the market. The private sector would become the primary lender on water projects in the state.

Agency officials are hesitant to use the buy-down approach as the primary method of financing water projects. They are hesitant because financial grants used to reduce interest rate expense under the buy-down approach may eventually deplete the program if additional appropriations or alternative funding methods are not authorized. Our analysis confirmed that the buy down approach depletes the program. However, we also found that low interest rate revolving-loans also deplete the program. Every time the state makes a loan at an interest rate below

the prevailing market rate, the program is eroded. The program is eroded because the bonds issued by local governments as security on the loans from the state are discounted in value because they are issued at the same, below the market interest rate, as the loans. The discount occurs because investors are unwilling to pay the full amount for bonds yielding less than the market rate of interest. Essentially, the discount the state incurs on the bonds equates to a financial subsidy from the state to the local government issuing the bond. This is why financial professionals refer to the state's revolving-loan program as a "disguised grant" program. It is also one of the reasons why the Legislature is asked for additional appropriations to fund the program on a regular basis.

If the Legislature elects to emphasize the use of interest rate buy-downs as the primary mechanism for assisting local governments with water projects, there will still be a need to maintain a modest revolving-loan program to assist communities that are unable to access the market. We found that some communities are unable to meet the credit and financial standards required by the market. For these communities, the state may be the only source of financing. Ultimately, the Legislature must determine whether the objective of the program would best be met by the interest rate buy-down approach or the revolving-loan approach.

Alternative Funding Approaches Should be Considered: Our analysis found that the Legislature should consider alternative methods for funding the water loan program. Currently, funding for the program comes from direct appropriations. However, state officials and financial professionals suggest there are other methods of funding that could be used. Three of the alternative funding methods proposed include: (a) establishing a trust fund; (b) using a recapitalization approach; and (c) adopting the bond banking method.

Proponents of these proposals suggest that they could be used individually or in combination with one another to reduce the demand for Legislative appropriations to fund the program. Under the trust fund proposal, the state would liquidate its bond portfolio. Proceeds from the liquidation would be placed in a dedicated trust where the principal would remain untouched. Interest earned on the trust would be used to finance interest rate buy-downs year after year in perpetuity. Under the recapitalization proposal, the state would pledge the repayment stream from the water loan portfolio as security for issuing new state water revenue bonds. Proceeds from the state water revenue bond would be used to recapitalize the program. This approach immediately recirculates the loans instead of waiting for the loans to mature. Under the bond bank proposal, the state would survey the needs of local governments for water projects each year. After determining the combined need, the state would then issue revenue or general obligation bonds on behalf of the local governments to finance the projects. This approach lowers the overall cost of the projects because the state is able to obtain a lower interest rate on bond issues based on its excellent credit rating. Experts estimate an interest rate savings of about 0.25 to 0.75 percent could be achieved on each project.

The Legislature may want to consider testing the proposed funding alternatives on a limited basis to determine how well they perform under real circumstances. Estimates show the demand for water projects will continue to increase as the state continues to grow and prosper. The Legislature will be faced with increasing pressure to fund additional water project development. The alternative funding methods discussed in this report may help the Legislature meet some of the future funding needs.

Consolidation of Water Boards Would Probably not Result in Greater Efficiency:

Our analysis concluded that greater efficiency would probably not result from consolidating the four water boards. We found that each of the boards administers uniquely different regulatory programs---programs that probably could not be efficiently combined. In addition, we found relatively few jointly funded projects. On the jointly funded projects we tested, we found no significant overlap or duplication of services. However, we did find that the boards have not fully utilized a coordinating council authorized by the Legislature or filled an investment banking officer position authorized by the Legislature. In our opinion greater efficiency could possibly result, particularly in the finance/loan function administered by the boards, if the coordinating council was fully utilized and the investment banking officer position filled. The coordinating council is discussed in Chapter 4 and the investment banking officer position is discussed in Chapter 2.